



Appeal of Donald D. Harwood

On his 1972 return, appellant claimed an "embezzlement loss" deduction of \$11,150 allegedly incurred in a stock purchase. Respondent determined from the record that there was no fraudulent taking or embezzlement and disallowed an ordinary loss deduction, treating the loss as a capital one. Appellant's protest against this action was denied and this appeal followed. In the course of the appeal, appellant contended, as an alternative, that the claimed loss was incurred in a transaction for profit, but respondent rejects this theory also. Thus, the issue to be decided is whether appellant's claimed loss is ordinary or capital in nature.

In late 1970, appellant met Federico Carstens, who represented himself as a principal of OPRISA (Ocean Products and Resources International, S.A.), a Panamanian corporation formed to develop fish protein concentrate (FPC) for human consumption. Carstens stated that Panama was a good location for an FPC plant, and that various unnamed individuals had made substantial investments in the corporation. Appellant was invited to invest in OPRISA, and from January to April 1971, he paid a total of \$12,500 to Carstens toward the acquisition of 20,000 shares of stock. It was also agreed that appellant would become a corporate officer and director. In turn, appellant received a translated copy of the corporate charter from Henry L. Newell, the Panamanian lawyer who acted as Carsten's counsel in forming OPRISA. During this time, appellant began preparing for his association with OPRISA by contacting an engineering firm which had built a FPC plant in Washington, and by taking Spanish lessons.

In April 1971 appellant met with Carstens and Newell in Panama but apparently did not see any corporate offices. Later that month, Carstens wrote to appellant: "The stock certificates are here and ready." Appellant never received any stock certificates and had little success contacting Carstens thereafter.

In 1972 appellant began demanding that Carstens return his money, but received no communication from Carstens except two postcards from London. Appellant considered the possibility of filing a fraud action against Carstens but was advised by Newell that Panamanian jurisdiction over Carstens would be difficult to obtain. Appellant then concluded that OPRISA was not actively engaged in any business and that he would not get his money back. Still, he continued attempts to locate Carstens, enlisting the aid of Henry Newell.

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Newell's first response, in 1973, stated that he had OPRISA's corporate charter on file but had been unable to locate Carstens. Newell also stated that he had advised Carstens not to sell stock without proper authority. Appellant requested further investigation and he received additional information from Newell. This was included in a sworn declaration in 1976, in which Newell summarized his experience with OPRISA as follows, in part: (1) Newell knew of no office or bank account established by OPRISA, nor of any corporate business conducted; (2) the stock certificate book ordered by Carstens was intact in Newell's files; (3) Newell had received information in 1973 (from unidentified sources) that Carstens was selling OPRISA stock overseas and representing Newell, among others, as a shareholder; and (4) Newell had had no contact with Carstens since 1973.

Appellant has offered two different theories on which his position is based and we will examine them separately, keeping in mind that respondent's disallowance of a deduction is presumed 'correct and the burden is on the taxpayer to prove his entitlement to it. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Appeal of Nake M. Kamrany, Cal. St. Bd. of Equal., Feb. 15, 1972.) Where, as here, the claim is for a refund, the appellant must establish by a preponderance of the evidence that he paid more income tax than was rightfully due. (Kubik v. United States, 31 AFTR 2d 73-754 (1972).)

Appellant's initial contention is that Carstens embezzled the money which appellant paid for stock, entitling appellant to an ordinary loss deduction under section 17206, subdivision (c) (3) of the Revenue and Taxation Code. In order to claim such a loss, appellant must establish the elements of the alleged criminal appropriation of appellant's money under the law of the jurisdiction where the loss was sustained, i.e., California, (Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956)), although it is not necessary to prove a criminal conviction. (Michele Monteleone, 34 T.C. 688 (1960).) California defines embezzlement as "the fraudulent appropriation of property by a person to whom it has been entrusted." (Pen. Code, § 503.) Thus, appellant must show that Carstens converted appellant's money to his personal use, rather than applying it to the purchase of OPRISA stock. This must have been done with the criminal intent to permanently deprive appellant of his property. (Bellis v. Commissioner, 540 F.2d 448 (9th Cir. 1976).) Whether Carstens had such intent must be determined from all the circumstances.

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Appellant has provided evidence that some of Carstens' promotional activities were less than straightforward. However, much of the information which is available consists of general allegations whose source and date are unidentified. While Carstens' behavior is questionable, as respondent observes, it may only indicate overzealous promoting which failed. The factors which appellant asserts as evidence of theft raise suspicions but do not lead inevitably to a conclusion of embezzlement, and where a theft loss is alleged, it must be shown that the loss was a product of circumstances which clearly and convincingly indicate theft. (Michele Monteleone, supra.) There is no certainty as to where or for what purpose Carstens expended appellant's funds nor is there more than a vague allegation that Carstens repeatedly sold stock against Newell's advice. No evidence indicates that appellant's stock purchase was void under Panamanian law, even though it apparently did not strictly comply with legal requirements. And under California law at the time of the sale, the transaction without a permit to sell securities would merely have been voidable within a prescribed period of time. (Corp. Code, §§ 25110, 25503, 25507, subd. (a).) Absent other evidence, we can not infer the intent required for theft solely because Carstens sold stock without first obtaining a permit. (See Bellis v. Commissioner, supra.) While we do not question Henry Newell's credibility, we must conclude that his statements are insufficient to sustain a finding of a loss by theft. In cases where such a loss has been upheld, the taxpayers have presented substantive evidence, for example, a withdrawal of funds from the corporate bank account and conversion to the promoters' personal use (Paul C. F. Vietzke, 37 T.C. 504 (1961) ) or an admission in a civil suit of the misapplication of taxpayer's money. (Michele Monteleone, supra.) We realize that it may be difficult for (appellant to provide more detailed evidence to support the allegations against Carstens; however, this does not relieve appellant of his burden of proving entitlement to the deduction.' (Burnet v. Houston, 283 U.S. 223 [75 L. 'Ed. 991] (1931).) Accordingly, we find that there is insufficient proof here of a loss by embezzlement. <sup>1/</sup>

<sup>1/</sup> Appellant's alternate theft theory concerned a taking by false pretenses. But because there is no evidence that Carstens' representations to appellant were indeed false, we conclude that appellant has failed to meet his burden of proof on this issue.

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Appellant's second contention is that he is entitled to a deduction for an ordinary loss sustained in a transaction for profit within the meaning of section 17206, subdivision (c)(2) of the Revenue and Taxation Code. In order to claim a deduction under this subdivision, the taxpayer's primary motive in entering a transaction must be to derive a profit. (Theodore B. Jefferson, 50 T.C. 963 (1968).) However, in the instant case, there is no evidence that appellant's acquisition of stock in OPRISA was invalid; thus, any profit to be derived would necessarily be in the form of dividends or profit on a subsequent sale of appellant's shares. In addition, appellant sold a portion of his OPRISA interest to a third party. These facts clearly characterize the instant transaction as the acquisition of a capital asset, and loss resulting from the stock becoming worthless must be treated as a loss from the sale or exchange of a capital asset (Rev. & Tax. Code, § 17206, subd. (g)) to the extent allowed by section 18152 of the Revenue and Taxation Code. We believe appellant has demonstrated that for all purposes, his investment lost its value when he lost communication with Carstens. Without contact with the principal activist behind OPRISA's development, appellant obviously could not expect any return on his investment. For that reason, we believe respondent was correct in allowing appellant a deduction for a capital loss on worthless stock.

For the above reasons, respondent must be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Donald D. Harwood for refund of personal income tax in the amount of \$1,115.10 for the year 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July, 1978, by the State Board of Equalization.

*George R. Young*, Chairman  
*Paul A. Allen*, Member  
*William H. Bennett*, Member  
*Iris Sankey*, Member  
                                , Member